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Stay abreast and prepare for new repairs vs. capitalization regulations

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For many property owners, the new repair vs. capitalization regulations are confusing and leave some in the dark on the temporary regulations they should now be following. From an accounting perspective, significant changes in the tax treatment of property repairs and improvements could have a direct impact on the bottom line this year and in future years for those in the real estate industry.

Under new temporary regulations issued by the Internal Revenue Service, projects ranging from the installation of a new roof to the replacement of an aging furnace will likely no longer be deductible. Instead, such projects will have to be capitalized and depreciated, thus diluting the tax advantages of many property improvements.

Then and Now

The new temporary regulations issued for Section 263(a)came as a bit of a surprise to the real estate industry. Although these rules have been under review for nearly a decade, absence of clear guidelines previously allowed property owners to claim many improvements as repairs, making the total cost deductible in a single year. Last year, for example, a new roof that cost $200,000 may have been claimed as a deductible expense, creating a tax savings of $80,000 for a taxpayer in the 40% bracket. That cash could have gone back into the company or been used elsewhere. This year, the same project must be capitalized and depreciated over a 39 (commercial) or 27.5 (residential) year period. This results in only a $2,000 or $3,000 current tax savings.

The result is that companies may be facing larger tax bills and feeling the impact on their bottom line. There are, however, some significant planning opportunities, thanks to provisions that allow taxpayers to write off items that were replaced before being fully depreciated.

For example, the rules may say a new roof is to be depreciated over 39 years, but it is unlikely that any roof will last that long. Under the new temporary regulations, taxpayers who can determine the value of the old roof can now write off the remaining carrying value when that roof is replaced.

Take Inventory

Taxpayers who capitalized rather than deducted their repairs and improvements may now be able to reach back and deduct the remaining carrying value as an expense. The challenge is determining the value of the item that has been replaced, whether it was a roof, a furnace, electrical wiring or a security system. This will change the way companies internally account for everything.

Purchasers of a building who in the past typically never bothered to identify the cost of individual components of that building should now track everything. For real estate, the IRS definition of a unit of property is very specific, including a building, its structural components and nine separate building systems ranging from elevators to plumbing.

The IRS still has some work to do on these temporary regulations, particularly when it comes to determining whether something is a repair or an improvement. Unfortunately, there are lots of cases where the distinction between an expense and a deduction is less clear. The IRS is expected to provide clearer guidance in the future on how taxpayers can distinguish between the two.

Take Heed

Because the IRS is still seeking comment on this particular aspect of the regulations, some taxpayers may be tempted to ignore the temporary rules until the final version is approved. However, the major issue—determining the definition of a unit of property for which improvements must be capitalized—is unlikely to change.

The implementation of these temporary regulations does not mean that property owners should forego necessary repairs or delay improvements. In fact, they should conduct business as usual. They will just have to account for it differently. Be sure to consult your advisor regarding the new regulations as part of your planning.

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